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SUBJECT: MEXICO 2007 INVESTMENT CLIMATE STATEMENT -- PART I

REF: 06 SECSTATE 178303

This is part one of a two part cable that provides suggested text for the 2007 Mexico Investment Climate Statement.

Openness to Foreign Investment

Mexico is open to foreign direct investment (FDI) in most economic sectors and has consistently been one of the largest recipients of FDI among emerging markets. In recent years, however, Mexico has become less competitive relative to other emerging economies, particularly China, but also India and countries in Eastern Europe, as it has failed to address serious crime and safety issues or pass much needed fiscal, labor and energy sector reforms. Recent reports from AT Kearney, Transparency International, the World Economic Forum and the Organization for Economic Cooperation and Development (OECD) have detailed the perceived decline in Mexico's attractiveness as an investment destination.

Foreign investment in Mexico has largely been concentrated in the northern states close to the U.S. border where most maquiladoras are located, and in the Federal District of Mexico City. The Yucatan peninsula, historically an area for tourism investment, has seen industry in other sectors grow due in part to the ability to quickly send goods from its ports to the United States. Financial services, automotive and electronic sectors have received the largest amounts of FDI. Historically, the United States has been the largest source of FDI in Mexico. As of September, U.S. investors had provided 61.5 percent of 2006 FDI.

The Government of Mexico has had some success in simplifying the process of investing in Mexico. The Secretariat of Economy (SECON) maintains a Spanish-language website (www.economia.gob.mx) offering an array of information, forms, links and transactions. Among other options, interested parties can download import/export permit applications, make on-line tax payments, and chat with on-line advisors who can answer specific investment and trade related questions.

The SECON website also contains a link to the Rapid Business Start-Up System (SARE), set up through an executive decree by President Fox in January 2002. SARE reduces the time and number of government formalities required to open a low-risk business. State governments, notably Nuevo Leon, have also passed small business facilitation measures to make it easier to open businesses. Despite progress however, according to a World Bank study it takes on average 27 days to complete all paperwork required to start a business in Mexico; compared to an average OECD figure of 17 days. The Embassy advises potential investors to contact SECON for detailed information on investing in Mexico. The address and telephone number for SECON is:

Secretaria de Economia,

SIPDIS
Alfonso Reyes No. 30,
Col. Hipodromo Condesa
C.P. 06179,
Mexico, D.F.
Tel: 52-55-5729-9100

The 1993 Foreign Investment Law is the basic statute governing foreign investment in Mexico. The law is consistent with the foreign investment chapter of NAFTA (the North American Free Trade Agreement). It provides national (i.e. non-discriminatory) treatment for most foreign investment, eliminates performance requirements for most foreign investment projects, and liberalizes criteria for automatic approval of foreign investment.

The Foreign Investment Law identifies 704 activities, 656 of which are open for 100 percent FDI stakes. There are 18 activities in which foreigners may only invest 49 percent; 13 of which require Foreign Investment National Commission approval for a 100 percent stake; 5 reserved for Mexican nationals; and 10 reserved for the Mexican state.

Below is a summary of activities subject to investment restrictions.

TABLE I
SECTION 1: SECTORS RESERVED FOR THE STATE IN WHOLE OR IN PART:

A) Petroleum and other hydrocarbons;
B) Basic petrochemicals;
C) Telegraphic and radio telegraphic services;
D) Radioactive materials;
E) Electric power generation, transmission, and distribution;
F) Nuclear energy;
G) Coinage and printing of money;

H) Postal service;
I) Airports;
J) Control, supervision and surveillance of ports and heliports.

SECTION 2: SECTORS RESERVED FOR MEXICAN NATIONALS:

A) Retail sales of gasoline and liquid petroleum gas;
B) Non-cable radio and television services;
C) Credit Unions, Savings and Loan Institutions, and Development Banks;
D) Certain professional and technical services;
E) Domestic transportation for passengers, tourism and freight, except for messenger or package delivery services.

U.S. and Canadian investors generally receive national and most-favored-nation treatment in setting up operations or acquiring firms. Exceptions exist for investments for which the Government of Mexico recorded its intent in NAFTA to restrict certain industries to Mexican nationals. U.S. and Canadian companies have the right under NAFTA to international arbitration and the right to transfer funds without restrictions. NAFTA also eliminated some barriers to investment in Mexico, such as trade balancing and domestic content requirements. Local governments must also accord national treatment to investors from NAFTA countries. Mexico is also a party to several OECD agreements covering foreign investment, notably the Code of Liberalization of Capital Movements and the National Treatment Instrument.

Approximately 95 percent of all foreign investment transactions do not require government approval. Foreign investments requiring applications and not exceeding USD 165 million are automatically approved, unless the proposed investment is in a sector subject to restrictions by the Mexican constitution and Foreign Investment Law that reserve certain sectors for the state and Mexican nationals (see Table 1). The National Foreign Investment Commission determines whether investments in restricted sectors may go forward and has 45 working days to make a decision. Criteria for approval include employment and training considerations, technological contributions,

and contributions to productivity and competitiveness. The Commission may reject applications to acquire Mexican companies for national security reasons. The Secretariat of Foreign Relations (SRE) must issue a permit for foreigners to establish or change the nature of Mexican companies.

Energy

The Mexican constitution reserves ownership of the petroleum and other hydrocarbon reserves located within Mexico. Oil and gas exploration and production efforts are under the sole purview of Pemex, Mexico's petroleum parastatal. The constitution also provides that most electricity service may only be supplied by two state-owned companies, the Federal Electricity Commission (CFE) and Central Power and Light (LYFC). There has been some opening to private capital. Private electric co-generation and self-supply are now allowed. Private investors may build independent power projects but all of their output must be sold to the Federal Electricity Commission in wholesale transactions. Private construction of generation for export is permitted. In 1995, amendments to the Petroleum Law opened transportation, storage, marketing and distribution of natural gas imports and issued open access regulations for Pemex's natural gas transportation network. Retail distribution of Mexico's natural gas is open to private investment, as is the secondary petrochemical industry. Since the government's announcement in August 2001 that national and foreign private firms will be able to import liquefied petroleum gas duty-free, one LNG terminal has begun operation in Tamaulipas state, a second is under construction in Baja California, and CFE is bidding a third on Mexico's Pacific Coast.

Multiple Service Contracts (MSCs), designed to comply with the country's constitution, mark Mexico's most ambitious effort to attract private companies to stimulate natural gas production by developing non-associated natural gas fields. Under an MSC contract, private companies will be responsible for 100 percent of the financing of a contract and will be paid for the work performed and services rendered. However, the natural gas produced in a specific field remains the property of Pemex. Examples of work that contractors can perform include seismic processing and interpretation, geological modeling, fields engineering, production engineering, drilling, facility design and construction, facility and well maintenance, and natural gas transportation services. Some Mexican politicians still oppose MSCs as a violation of the Mexican constitution's ban on concessions. Some contracts have failed to attract any bids, demonstrating the limited success of MSCs.
Minor changes to the regime through which Pemex remits funds to the

Federal Government passed in November 2005 and further limited changes are contemplated in the current legislative session to reform specific aspects of Pemex's commercial operations.

Telecommunications

Mexico allows up to 49 percent FDI in companies that provide telecommunications networks and services. This includes the Cable TV (CATV) industry, with one exception: companies can issue Neutral or "N" stocks up to 99 percent, which can be owned by a foreign company. In fact, one CATV company operates under this ownership scheme. There is no limit on FDI in companies providing cellular services. However, Telmex continues to reign as the dominant telecom power and wields significant influence over key regulatory and government decision makers. Mexico's dominant landline and wireless carriers are traded on the New York Stock Exchange.

Several large U.S. and international telecom companies are active in Mexico, partnering with Mexican companies or holding minority shares. Following a 2004 WTO ruling, international resellers are authorized to operate in Mexico and so some companies are also looking to sell wholesale minutes to resellers.   Telcel (technically independent, but majority owned by Telmex owner's Grupo Carso) still retains a majority share (about 70 percent) of the cellular market. However, Spain's Telefonica Movistar, among

others, continues to grow and challenge the status quo. They have deployed extensive mobile infrastructure to increase coverage around the country.

Telmex continues and will continue to dominate the market in Long Distance (local and international), Internet access through DSL, and bundle services. A new Convergence Accord, published in October, allows Telmex to offer broadcasting or TV services. The Federal Telecommunications Commission has not found any legal reason that Telmex would be required to pay a fee to the government for the privilege, but the Secretariat of Economy is reviewing the issue. The accord has elicited strong concerns from the CATV industry, which fears that it will push CATV operators to consolidate. However, under the accord, CATV operators (including TV duopolist Televisa's Cablevision) will also be allowed to begin providing telephone services, which might increase competition in the telephony market.

As in telecommunications, there are concerns that the two dominant television companies - Televisa and TV Azteca, who share duopoly status in the sector - continue to exercise influence over Mexican judicial, legislative, policy, and regulatory bodies to prevent competition. The Radio and Television Law passed in March 2006 has been criticized as catering to the interests of dominant industry players by imposing permanent disadvantages on new entrants as compared to the current dominant duopoly.

U.S. firms remain unable to penetrate the Mexican television broadcast market, despite the fact that both Televisa and TV Azteca benefit from access to the U.S. market. TV Azteca has used the Mexican legal system to harass a U.S. firm trying to enter this sector. This harassment included TV Azteca personnel directing a raid, with the support of Mexico City auxiliary police, on production facilities for the purpose of stopping production of a show in Mexico for U.S. Spanish-speaking audiences and thereby obtaining relief that Azteca could not legitimately obtain in the United States. Mexico's television ad market is estimated to be worth in excess of 2.5 USD billion annually.

Real Estate

Investment restrictions still prohibit foreigners from acquiring title to residential real estate in so-called "restricted zones" within 50 kilometers (approximately 30 miles) of the nation's coast and 100 kilometers (approximately 60 miles) of the borders. In all, the restricted zones total about 40 percent of Mexico's territory. Nevertheless, foreigners may acquire the effective use of residential property in the restricted zones through the establishment of a 50-year extendible trust (called a fideicomiso) arranged through a Mexican financial institution that acts as trustee.

Under a fideicomiso the foreign investor obtains all rights of use of the property, including the right to develop, sell and transfer the property. Real estate investors should, however, be careful in performing due diligence to ensure that there are no other claimants to the property being purchased. Fideicomiso arrangements have led to legal challenges in some cases. Title insurance has recently become available in Mexico and a few major U.S. title insurers have begun operations here.

Transport

The Mexican government allows up to 49 percent foreign ownership of 50-year concessions to operate parts of the railroad system, renewable for a second 50-year period. The Mexican Foreign Investment Commission and the Mexican Federal Competition Commission (CFC) must approve ownership above 49 percent. In a positive sign for competition, the CFC recently struck down a proposed merger between two of the three major railroad companies. The decision may still be appealed. Consistent with NAFTA, foreign investors from the U.S. and Canada are now permitted to own up to 100 percent of local trucking and bus companies, however, several companies have

encountered long wait times and legal tie-ups when trying to obtain permits.

CINTRA, the government holding company for the Mexican airline groups, Mexicana and Aeromexico, sold Grupo Mexicana to Grupo Posadas in December 2005. Rumors of plans to sell Grupo Aeromexico still abound, although the timing of the proposed sale is still uncertain. These sales, coupled with the emergence of new low-cost start-ups are likely to change the dynamics of Mexican aviation in the short to medium term. Despite blossoming competition, foreign ownership of Mexican airlines is capped at 25 percent. Foreign ownership in airports is limited to 49 percent. Express delivery service companies continue to complain that Mexican legislation unfairly favors Mexican companies by restricting the size of trucks international carriers are allowed to use.

Conversion and Transfer Policies

Mexico has open conversion and transfer policies as a result of its membership in NAFTA and the OECD. In general, capital and investment transactions, remittance of profits, dividends, royalties, technical service fees, and travel expenses are handled at market-determined exchange rates. Peso/dollar foreign exchange is available on same-day, 24- and 48-hour settlement bases. Most large foreign exchange transactions are settled in 48 hours. In June 2003, the U.S. Federal Reserve Bank and the Bank of Mexico announced the establishment of an automated clearinghouse for cross-border financial transactions. The International Electronic Funds Transfer System (TEFI) began operating in 2004 and commissions on transfers through the system have dropped rapidly.

Expropriation and Compensation

Under NAFTA, Mexico may not expropriate property, except for a public purpose and on a non-discriminatory basis. Expropriations are governed by international law, and require rapid fair market value compensation, including accrued interest. Investors have the right to international arbitration for violations of this or any other rights included in the investment chapter of NAFTA. There have been twelve arbitration cases, six of which are still pending, filed against Mexico by U.S. and Canadian investors who allege expropriation, and other violations of Mexico's NAFTA obligations. Details of the cases can be found at the Department of State Website, Office of the Legal Advisor (www.state.gov/s/l).

Dispute Settlement

Chapter Eleven of NAFTA contains provisions designed to protect cross-border investors and facilitate the settlement of investment disputes. For example, each NAFTA Party must accord investors from the other NAFTA Parties national treatment and may not expropriate investments of those investors except in accordance with international law.

Chapter Eleven permits an investor of one NAFTA Party to seek money damages for measures of one of the other NAFTA Parties that allegedly violate those and other provisions of Chapter Eleven. Investors may initiate arbitration against the NAFTA Party under the Arbitration Rules of the United Nations Commission on International Trade Law ("UNCITRAL Rules") or the Arbitration (Additional Facility) Rules of the International Center for Settlement of Investment Disputes ("ICSID Additional Facility Rules"). Alternatively, a NAFTA investor may choose to use the registering country's court system.

The Mexican government and courts recognize and enforce arbitral awards. The Embassy has heard of no actions taken in the Mexican courts for an alleged Chapter 11 violation on behalf of U.S. or Canadian firms.

There have been numerous cases in which foreign investors, particularly in real estate transactions, have spent years dealing with Mexican courts trying to resolve their disputes. Often real

estate disputes occur in popular tourist areas such as the Yucatan. American investors should understand that under Mexican law many

commercial disputes that would be treated as civil cases in the U.S. could also be treated as criminal proceedings in Mexico. Based upon the evidence presented a judge may decide to issue arrest warrants. In such cases Mexican law also provides for a judicial official to issue an "amparo" (injunction) to shield defendants from arrest. U.S. investors involved in commercial disputes should therefore obtain competent Mexican legal counsel, and inform the U.S. Embassy if arrest warrants are issued.

Performance Requirements and Incentives

The 1993 Foreign Investment Law eliminated export requirements (except for maquiladora industries), capital controls, and domestic content percentages, which are prohibited under NAFTA. Foreign investors already in Mexico at the time the law became effective could apply for cancellation of prior commitments. Foreign investors who failed to apply for the revocation of existing performance requirements remained subject to them.

The Mexican federal government has eliminated direct tax incentives, with the exception of accelerated depreciation. A comprehensive fiscal reform package including changes to corporate, individual, and other taxes has been proposed. Some changes to tax law under this framework were approved with the 2005 Revenue Bill, reducing income tax rates on a gradual basis. Needed comprehensive fiscal reform has stalled although the current administration has indicated it will pursue the matter in the coming years. Investors should follow this development closely as whatever reforms that ultimately emerge could have implications for investors.

Most taxes in Mexico are federal; therefore, states have limited opportunity to offer tax incentives. However, Mexican states have begun competing aggressively with each other for investments, and most have development programs for attracting industry. These include reduced price (or even free) real estate, employee training programs, and reductions of the 2 percent state payroll tax, as well as real estate, land transfer, and deed registration taxes. Four northern states - Nuevo Leon, Coahuila, Chihuahua and Tamaulipas - have signed an agreement with the state of Texas to facilitate regional economic development and integration. Investors should consult the Finance, Economy, and Environment Secretariats, as well as state development agencies, for more information on fiscal incentives. Tax attorneys and industrial real estate firms can also be good sources of information.

U.S. Consulates have reported that the states in their consular districts have had to modify their incentive packages due to government decentralization. Many states have also developed unique industrial development policies. Sonora, for example, is working to expand the free entry area for tourists (south from the border to the port of Guaymas). Sonora is one state that has implemented long-term agriculture and infrastructure development plans. The government of Yucatan provides information and support to potential investors and business entrepreneurs through several programs that target different industries such as technology, agroindustry and energy exploration.

There is a government-owned development bank, Nacional Financiera, S.A. (www.nafin.com), which provides loans to companies in priority development areas and industries. It is active in promoting joint Mexican-foreign ventures for the production of capital goods. Nacional Financiera offers preferential, fixed-rated financing for the following types of activities: small and medium businesses; environmental improvements; studies and consulting assistance; technological development; infrastructure; modernization; and capital contribution. The Mexican Bank for Foreign Trade, Bancomext, offers a variety of export financing and promotion programs (www.bancomext.com).

Mexico has two programs to stimulate manufactured exports - maquiladora and PITEX (Program for Temporary Imports to produce Exports) - that largely operate in the same manner. The first is focused on companies that specialize in in-bond manufacturing and export, while the second is for companies that may have significant domestic sales. In November 2006, the maquiladora and PITEX programs were combined into the renamed IMMEX (Industria Manufacturera, Maquiladora y Servicios de Exportacion) program. The IMMEX program adds services, such as business process outsourcing, to the maquila

scheme and also simplifies and streamlines the processes under the two previous schemes. The new program will continue to exempt companies from import duties and applicable taxes (e.g. VAT) on inputs and components incorporated into exported manufactured goods. In addition, capital goods and the machinery used in the production process are tax exempt, but are currently subject to import duties.

Companies interested in investing in industrial activity in Mexico need to follow the new IMMEX guidelines closely, preferably in close consultation with locally based legal advisors. Please refer to the Secretariat of Economy's IMMEX program website at: http://www.economia.gob.mx/?P=2297

In order to maintain competitiveness of maquiladora and PITEX companies and comply with NAFTA provisions, since 2001 Mexico has applied "Sectoral Promotion Programs" (PROSEC). Under these programs, most favored nation import duties on listed inputs and components used to produce specific products are eliminated, or reduced to a competitive level. These programs comply with NAFTA provisions because import duty reduction is available to all producers, whether the final product is sold domestically or is exported to a NAFTA country. Currently there are 22 PROSECs, including electronics and home appliances, automotive and auto-parts, textile and apparel, footwear, and others. The lists of inputs and components incorporated under each PROSEC are not exhaustive, and the Mexican government regularly consults with industries to include more goods.

In the last three years the Secretariat of Economy conducted, in partnership with the private sector, 12 studies, called "Programs for Sectoral Competitiveness", of the country's most important sectors according to their levels of exports, employment and FDI. Studies covering the electronics, automotive, textile, maquiladora, leather and footwear, and software sectors are currently available at the website of the Secretary of Economy: (http://www.economia.gob.mx/index.jsp?P=944).

Right to Private Ownership and Establishment

Foreign and domestic private entities are permitted to establish and own business enterprises and engage in all forms of remunerative activity in Mexico, except those enumerated in Section 1 Table 1. Private enterprises are able to freely establish, acquire and dispose of interests in business enterprises. The two most common types of business entities are corporations (Sociedad Anonima) and limited partnerships (Sociedad de Responsibilidad Limitada). Under these legal entities a foreign company may operate an independent company, a branch, affiliate, or subsidiary company in Mexico. The rules and regulations for starting an enterprise differ for each structure.

Corporation (Sociedad Anonima)	Limited Liability Company (Sociedad de Responsibilid Limitada)
Can be up to 100 percent foreign-owned.	Can be up to 100 percent foreign-owned.
Must have a minimum of 50,000 Mexican pesos in capital stock to start.	Must have a minimum of 3,000 Mexican pesos in capital stock to start.
Must have minimum of 2 shareholders, with no maximum. Board of Directors can run the administration of the company.	Must have a minimum of 2 partners to incorporate a corporation with limited liability. The partners must manage the company.
The enterprise has an indefinite life span.	Exists only while there is a business purpose and partners remain the same.
Free transferability of stock ownership is permitted.	Restricted transferability of partnership shares. Any changes in the

	partnership composition may cause the partnership to be liquidated.
Operational losses incurred by the Mexican entity or subsidiary may not be used by the U.S. parent company.	If structured properly, it may offer tax advantages by allowing operational losses incurred by the Mexican entity to be used by the U.S. parent company.
Limited liability to shareholders.	Limited liability is afforded the partners.

Protection of Property Rights

Two different laws provide the core legal basis for protection of intellectual property rights (IPR) in Mexico -- the Industrial

Property Law (Ley de Propiedad Industrial) and the Federal Copyright Law (Ley Federal del Derecho de Autor). Multiple federal agencies are responsible for various aspects of IPR protection in Mexico. The Office of the Attorney General (Procuradur!a General de la Republica, or PGR) has a specialized unit that pursues criminal IPR investigations. The Mexican Institute of Industrial Property (Instituto Mexicano de la Propiedad Industrial, or IMPI) administers Mexico's trademark and patent registries and is responsible for handling administrative cases of IPR infringement. The National Institute of Author Rights (Instituto Nacional del Derecho de Autor) administers Mexico's copyright register and also provides legal advice and mediation services to copyright owners who believe their rights have been infringed. The Mexican Customs Service (Aduana MQxico) plays a key role in ensuring that illegal goods do not cross Mexico's borders.

Despite strengthened enforcement efforts by Mexico's federal authorities over the past several years, weak penalties and other obstacles to effective IPR protection have failed to deter the rampant piracy and counterfeiting found throughout the country. The U.S. Government continues to work with its Mexican counterparts to improve the business climate for owners of intellectual property. Please refer to the Embassy's IPR Toolkit for more information: http://mexico.usembassy.gov/mexico/IPR.html

Mexico is a signatory of at least fifteen international treaties, including the Paris Convention for the Protection of Industrial Property, the NAFTA, and the WTO Agreement on Trade-related Aspects of Intellectual Property Rights. Though Mexico signed the Patent Cooperation Treaty in Geneva, Switzerland in 1994, which allows for simplified patent registration procedure when applying for patents in more than one country at the same time, it is necessary to register any patent or trademark in Mexico in order to claim an exclusive right to any given product. A prior registration in the United States does not guarantee its exclusivity and proper use in Mexico, but serves merely as support for the authenticity of any claim you might make, should you take legal action in Mexico.

An English-language overview of Mexico's IPR regime can be found on the WIPO website at:
http://www.wipo.int/about-ip/en/ipworldwide/p df/mx.pdf

Although a firm or individual may apply directly, most foreign firms hire local law firms specializing in intellectual property. The U.S. Embassy's Commercial Section maintains a list of such law firms in Mexico at:
http://www.buyusa.gov/mexico/en/business_serv ice_providers.html

Visit Mexico City's Classified Web Site at
http://www.state.sgov.gov/p/wha/mexicocity
GARZA